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RUEHGU/AMCONSUL GUADALAJARA 2375

RUEHYM/AMCONSUL MONTERREY 1646

ZEN/ALL USCONS MEXICO POUCH

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CONTROLS

C O N F I D E N T I A L MEXICO 03380DEPARTMENT PASS TO FEDERAL RESERVE BOARD, EXPORT IMPORT
BANK, USTR, AGRICULTURE AND COMMERCE

TREASURY FOR JIM FALL AND JANE BARDON, OASIA

E.O. 12356: DECL: 2/7/95

BODY

TAGS: EFIN, ECON, MX

SUBJECT: OBSERVATIONS ON THE MEXICAN PESO/U.S.DOLLAR

- EXCHANGE RATE AND ITS IMPORTANCE IN MEXICO'S

- ECONOMIC STRATEGY

1. EXCHANGE RATE POLICY IS ONE OF THE MOST CRITICAL
ELEMENTS IN THE MEXICAN GOVERNMENT'S PROGRAM TO STABILIZE
AND INCREASE THE COMPETITIVENESS OF THE MEXICAN ECONOMY.

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THE EXCHANGE RATE HAS BEEN THE ANCHOR OF THE ECONOMIC SOLIDARITY PACT WHICH WAS IN EFFECT DURING 1988 AND OF THE NEW PACT FOR ECONOMIC GROWTH AND STABILITY WHICH IS SCHEDULED TO BE IN EFFECT AT LEAST THROUGH JULY 1989. MEXICO'S KEY ECONOMIC POLICYMAKERS ARE CONCERNED THAT EXCHANGE RATE STABILITY AND PREDICTABILITY ARE KEY TO CONTROLLING INFLATION IN THE COUNTRY AND INSTILLING CONFIDENCE IN THE GOVERNMENT'S MACROECONOMIC POLICIES.

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2. THE MEXICAN AUTHORITIES BELIEVE THAT MOVEMENTS IN THE EXCHANGE RATE GENERALLY EXERT GREATER MACROECONOMIC CONSEQUENCES IN THIS COUNTRY THAN SIMILAR MOVEMENTS IN MOST OTHER COUNTRIES. EVEN THOUGH THE TRADED-GOODS SECTOR IS A RELATIVELY SMALL PORTION OF THE TOTAL MEXICAN ECONOMY, THE EFFECT OF PESO DEVALUATIONS IS MAGNIFIED BECAUSE THEY AFFECT QUICKLY NOT ONLY THE PRICES OF TRADABLE GOODS BUT ALSO OF OTHER GOODS AND SERVICES AND WAGES IN THE ECONOMY. IN FACT, THE NORMAL PATTERN IN MEXICO IS FOR A DEVALUATION TO LEAD TO RAPID INCREASES IN MOST NON-CONTROLLED PRICES IN THE COUNTRY AND TO DEMANDS FROM LABOR UNIONS FOR WAGE INCREASES, BOTH OF WHICH EXERT SUBSTANTIAL INFLATIONARY PRESSURES.

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3. THERE IS MUCH DEBATE IN MEXICO AS TO WHETHER THE PESO IS CURRENTLY UNDERVALUED, OVERVALUED, OR JUST ABOUT RIGHT FOR THE COUNTRY TO MAINTAIN A SUSTAINABLE POSITION IN ITS BALANCE OF PAYMENTS AND CONSERVE FOREIGN EXCHANGE RESERVES. IN GENERAL THE BUSINESS SECTOR WOULD LIKE TO SEE MORE RAPID DEVALUATION OF THE PESO IN ORDER TO HELP PROMOTE NON-PETROLEUM EXPORTS AND TO KEEP MEXICAN COMPANIES COMPETITIVE IN INTERNATIONAL MARKETS. HOWEVER, EVEN THOUGH THE PESO/DOLLAR EXCHANGE RATE WAS FROZEN FOR MOST OF 1988, NON-PETROLEUM EXPORTS CONTINUED TO GROW, RISING BY ABOUT 18 PERCENT FOR THE YEAR. THE MEXICAN GOVERNMENT IS PROJECTING THEY WILL GROW AN ADDITIONAL 15 PERCENT THIS YEAR (GIVEN PRESENT EXPORT TRENDS THIS FIGURE MAY BE OVERLY OPTIMISTIC ALTHOUGH INCREASED WORLD PETROLEUM PRICES SHOULD HELP TO BOOST TOTAL EXPORT RECEIPTS OVER WHAT THE GOVERNMENT HAD PROJECTED FOR 1989).

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4. ON THE OTHER HAND, IMPORTS GREW VERY RAPIDLY IN 1988, BY ABOUT 55 PERCENT, BOTH BECAUSE OF THE EXCHANGE RATE AND THE REDUCTION OF IMPORT LICENSING REQUIREMENTS AND TARIFF LEVELS. HOWEVER, THE GOVERNMENT ESTIMATES THAT IMPORT GROWTH WILL BE MUCH SLOWER IN 1989 BECAUSE THE ECONOMY IS IN A RECESSION AND BECAUSE MINIMUM TARIFFS HAVE BEEN INCREASED FROM ZERO TO 10 PERCENT (THE MEXICANS RECOGNIZE THAT THIS IS A TEMPORARY STEP BACKWARDS IN OPENING THE ECONOMY BUT THEY BELIEVE THAT IT IS THE LEAST INJURIOUS WAY TO TEMPER IMPORTS AND INCREASE FISCAL RECEIPTS). OFFICIALLY IMPORT GROWTH FOR 1989 IS PROJECTED AT 11.6 PERCENT (WE PROJECT IMPORTS WILL GROW MORE SLOWLY).

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5. PURCHASING POWER PARITY ANALYSIS, I.E., COMPARING RELATIVE COSTS AND WAGES IN THIS COUNTRY AND ITS MAJOR TRADING PARTNERS, YIELDS INTERESTING RESULTS FOR MEXICO. WITH EITHER 1977 OR 1978 AS THE BASE YEAR--AT THE END OF 1988 THE PESO CONTINUED TO BE SLIGHTLY UNDERVALUED OR ABOUT IN EQUILIBRIUM IN SPITE OF THE FACT THAT THE PESO APPRECIATED BY NEARLY 25 PERCENT IN REAL TERMS LAST YEAR. (1977 AND 1978 ARE OFTEN USED AS BASE YEARS BECAUSE IT IS BELIEVED THE PESO EXCHANGE RATE WITH THE DOLLAR AND WITH A BASKET OF CURRENCIES WAS APPROXIMATELY THAT REQUIRED FOR A SUSTAINABLE BALANCE OF PAYMENTS SITUATION, I.E., IT WAS AN APPROPRIATE EQUILIBRIUM RATE.) FOR EXAMPLE, BANAMEX--THE COUNTRY'S LARGEST COMMERCIAL BANK--PLACES THE LEVEL OF UNDERVALUATION OF THE PESO COMPARED TO THE DOLLAR AT THE END OF 1988 AT 3.7

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DEPARTMENT PASS TO FEDERAL RESERVE BOARD, EXPORT IMPORT BANK, USTR, AGRICULTURE AND COMMERCE

TREASURY FOR JIM FALL AND JANE BARDON, OASIA

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PERCENT COMPARED TO 34 PERCENT AT THE END OF 1987 (TABLE 1). USING A BASKET OF CURRENCIES THE BANK OF MEXICO CALCULATES THAT AS OF OCTOBER 1988 THE PESO WAS UNDERVALUED BY 3.9-7.9 PERCENT DEPENDING ON WHETHER 1977 OR 1978 WAS USED AS THE BASE YEAR (TABLE 2). ADDITIONALLY, THE CENTER FOR ECONOMIC STUDIES OF THE PRIVATE SECTOR CALCULATES THAT AT THE END OF LAST YEAR THE COMPETITIVENESS OF THE PESO VERSUS THE DOLLAR WAS JUST ABOUT THE SAME AS IT WAS IN 1977 (TABLE 3).

6. ANOTHER WAY THE MEXICANS USE TO DETERMINE THE OVERALL UNDERVALUATION OR OVERVALUATION OF THE PESO IS BY COMPARING RELATIVE WAGE RATES WITH THE COUNTRY'S MAJOR TRADING PARTNERS. AGAIN USING 1977 AS THE BASE YEAR THE PESO WOULD REMAIN CONSIDERABLY UNDERVALUED--ACCORDING TO BANAMEX BY 25 PERCENT (TABLE 1)--AT THE END OF 1988. THIS IS DUE PRIMARILY TO THE LARGE REAL DECREASE IN REAL WAGES THAT HAS OCCURRED IN MEXICO DURING THE PAST SIX YEARS.

(U)

TABLE 1
PERCENT UNDERVALUATION OF THE CONTROLLED
MARKET PESO AGAINST THE U.S. DOLLAR
(BASE YEAR EQUALS 1977)

RELATIVE COSTS	RELATIVE WAGES
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1987		
JANUARY	-36.7	-45.7
APRIL	-36.7	-46.0
JULY	-33.7	-43.5
OCTOBER	-28.1	-38.9
DECEMBER	-34.0	-46.4
-		
1988		
FEBRUARY	-20.0	-35.4
MAY	-12.7	-30.4
AUGUST	-9.6	-28.3
OCTOBER	-6.3	-26.3
DECEMBER	-3.7	-24.6

SOURCE: BANAMEX, OFFICE OF ECONOMIC RESEARCH

(U) TABLE 2
INDEX OF REAL MOVEMENTS IN THE MEXICAN PESO 1/
(BASED ON RELATIVE PRICE MOVEMENTS IN 133
COUNTRIES

-		BASE YEAR	
-		1977	
-	1970		1978
-			
1970	100.0	77.3	80.65
1975	99.3	72.9	76.05
1977	129.4	100.0	104.4
1978	124.0	95.9	100.0
1985	106.2	82.1	85.7
1987	170.4	131.7	137.4
-			
1988			
JANUARY	160.6	124.1	129.5
APRIL	142.7	110.3	115.1
JULY	133.4	103.1	107.6
OCTOBER	134.6	104.0	108.6

1/ INDEX IN EXCESS OF 100 INDICATES REAL DEPRECIATION OF
THE PESO COMPARED TO BASE YEAR.

SOURCE: BANK OF MEXICO, INDICADORES ECONOMICOS, P IV-22

(U) TABLE 3
GAIN OR LESS IN COMPETITIVENESS OF THE
PESO COMPARED TO THE DOLLAR
(1977 EQUALS 100)

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	FREE MARKET EXCHANGE RATE	CONTROLLED EXCHANGE RATE	THEOR- ETICAL EXCHANGE RATE	CHANGE IN COMPETI- TIVENESS FREE RATE	CHANGE/ COMPETI- TIVENESS CONT.RATE
12/82	100.0	67.7	73.5	-26.8	8.6
12/84	207.4	190.2	196.0	-5.5	3.0
12/87	2,240.8	2,023.4	1,515.0	-32.3	-25.1
2/88	2,269.3	2,231.4	1,859.2	-18.1	16.7
5/88	2,295.0	2,257.0	2,102.4	-8.4	-6.9
10/88	2,295.0	2,257.0	2,223.9	-3.1	-1.5
12/88	2,295.0	2,257.0	2,289.3	-0.2	1.4

NEGATIVE SIGN INDICATES INCREASED COMPETITIVENESS
COMPARED TO THE BASE YEAR.

SOURCE: MONTHLY REPORT OF THE CENTER FOR ECONOMIC
STUDIES OF THE PRIVATE SECTOR (CEESP), JANUARY 1989, PAGE
42.

7. OF COURSE RELATIVE WAGES AND PRICES ARE NOT THE ONLY
FACTORS IN DETERMINING WHAT THE LEVEL OF THE MEXICAN
EXCHANGE RATE SHOULD BE. THERE ARE OFTEN PRESSURES DUE
TO OTHER CONSIDERATIONS SUCH AS SPECULATION AGAINST THE
PESO (THE MEXICAN GOVERNMENT DOES NOT HAVE THE SAME
ABILITY TO INTERVENE IN THE FOREIGN EXCHANGE MARKETS AS
THE MAJOR INDUSTRIAL COUNTRIES), UNCERTAINTIES REGARDING
THE POLITICAL SITUATION AND PRESIDENTIAL TRANSITION
PERIODS, AND QUESTIONS RELATING TO OVERALL MACROECONOMIC
POLICY MANAGEMENT. HISTORICALLY, THESE PSYCHOLOGICAL
FACTORS HAVE AT TIMES BEEN MUCH MORE IMPORTANT IN FORCING
EXCHANGE RATE MOVEMENTS THAN UNDERLYING TECHNICAL
CONSIDERATIONS.

8. SOME ANALYSTS POINT TO THE LARGE LOSS IN FOREIGN
EXCHANGE RESERVES BETWEEN MAY AND DECEMBER OF 1988 AS A
SIGN THAT THE PESO EXCHANGE RATE NEEDED TO BE ADJUSTED.
HOWEVER, THIS IS NOT NECESSARILY THE CASE BECAUSE THE
DRAWDOWN IN FOREIGN EXCHANGE RESERVES WAS PARTLY DUE TO
THE FACT THAT THE GOVERNMENT WANTED TO FINANCE A PORTION
OF THE FISCAL DEFICIT WITH FOREIGN EXCHANGE (WHICH WAS
LESS EXPENSIVE THAN BORROWING IN THE DOMESTIC MARKETS),
BECAUSE THE PRIVATE SECTOR PREPAID EXISTING EXTERNAL
OBLIGATIONS ON ATTRACTIVE TERMS SO PRIVATE SECTOR FOREIGN
DEBT DECLINED MARKEDLY LAST YEAR, AND BECAUSE THE
GOVERNMENT USED SOME RESERVES IN CONNECTION WITH ITS DEBT
FOR BOND SWAP PROGRAM.

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9. OVER THE PAST MONTH OR SO MEXICAN FOREIGN EXCHANGE RESERVES HAVE RISEN MODESTLY. THIS SEEMS TO BE DUE TO SEVERAL FACTORS. FIRST, THE GOVERNMENT HAS ANNOUNCED THE CONTINUATION OF AN ECONOMIC PROGRAM DESIGNED TO BRING DOWN INFLATION AND TO CONTINUE WITH A MORE MARKET ORIENTED APPROACH. SECOND, THE NEW PRESIDENT HAS TAKEN OFFICE AND HE HAS MADE IT CLEAR THAT HE HAS A STRONG CHARACTER AND INTENDS TO IMPLEMENT IMPORTANT ECONOMIC AND POLITICAL CHANGES IN THE COUNTRY. THIRD, EVEN THOUGH THE PESO HAS BEGUN TO MOVE BY AN AVERAGE OF ONE PESO A DAY AGAINST THE U.S. DOLLAR, HIGH REAL DOMESTIC INTEREST RATES MAKE IT VERY ATTRACTIVE FOR INVESTORS TO HAVE THEIR MONEY IN PESO FINANCIAL ASSETS.

10. IT IS OBVIOUS THAT THE MEXICAN PESO EXCHANGE RATE ISSUE IS A COMPLEX ONE AND THERE ARE NO SIMPLE ANSWERS. THE AUTHORITIES MUST WALK A FINE LINE BETWEEN THE NEED TO MAINTAIN AN ADEQUATE LEVEL OF FOREIGN EXCHANGE RESERVES AND IMPLEMENT AN EXCHANGE RATE POLICY THAT WILL ALLOW CONTINUED PROGRESS IN REDUCING INFLATION IN THE COUNTRY. IN OTHER WORDS, DECISIONS REGARDING EXCHANGE RATE POLICIES MUST BALANCE ECONOMIC STABILIZATION CONSIDERATIONS WITH THE NEED TO CONTINUE TO PROMOTE NON-PETROLEUM EXPORTS, TEMPER IMPORTS, MEET THEIR DEBT PAYMENTS, AND MAINTAIN SUFFICIENT FOREIGN RESERVES. FOR THE TIME BEING, THE MEXICANS SEEM TO HAVE DECIDED THAT
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HIGH REAL DOMESTIC INTEREST RATES (WHICH CAUSE PRESSURES ON DOMESTIC FINANCIAL MARKETS AND ON THE PUBLIC SECTOR FINANCIAL DEFICIT BUT WHICH HELP TO ATTRACT CAPITAL INTO THE COUNTRY) ARE A PART OF THE COST OF EXCHANGE RATE STABILITY AND ARE LESS INFLATIONARY AND DESTABILIZING THAN WOULD BE A LARGE DEVALUATION OR MORE RAPID DAILY MOVEMENTS OF THE PESO AGAINST THE U.S. DOLLAR.

11. BECAUSE OF ITS IMPORTANCE IN THE BATTLE AGAINST INFLATION THE MEXICAN GOVERNMENT IS HOPING TO ALLOW THE PESO TO APPRECIATE BY ABOUT 4 PERCENT IN REAL TERMS DURING THE COURSE OF 1989 FOLLOWING A REAL APPRECIATION OF ABOUT 25 PERCENT LAST YEAR. AFTER ALLOWING THE EXCHANGE RATE TO FALL BY ONE PESO PER DAY (OR BY SLIGHTLY MORE THAN 9 PERCENT) FOR THE FIRST SEVEN MONTHS OF THE

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YEAR THEY WOULD LIKE TO STABILIZE IT THEREAFTER OR CONTINUE WITH THE SAME ONE PESO PER DAY POLICY DEPENDING UPON DOMESTIC INFLATION RATES AT THAT TIME.

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12. SO FAR THE ECONOMIC SOLIDARITY PACT AND ITS SUCCESSOR, THE PACT FOR ECONOMIC GROWTH AND STABILITY, HAVE SHOWN IMPRESSIVE RESULTS AND A KEY TO THEIR SUCCESS HAS BEEN EXCHANGE RATE POLICY. THE MEXICAN AUTHORITIES ARE CONVINCED THAT THEY HAVE TO KEEP EXCHANGE RATE MOVEMENTS SMALL AND PREDICTABLE FOR THE TIME BEING IF THEY ARE GOING TO WIN THE BATTLE AGAINST INFLATION. THEIR ABILITY TO HOLD THE LINE ON THE EXCHANGE RATE DEPENDS UPON MOVEMENTS IN THEIR FOREIGN EXCHANGE RESERVES. THEY ARE HOPING THAT A CONTINUED COMBINATION OF TIGHT FISCAL AND MONETARY POLICIES (INCLUDING HIGH REAL DOMESTIC INTEREST RATES), PROMOTION OF PRIVATE DOMESTIC AND FOREIGN INVESTMENT, DEVELOPMENT OF THE IN-BOND INDUSTRIES AND TOURISM, AND RISING PETROLEUM AND NON-PETROLEUM EXPORTS WILL HELP KEEP FOREIGN EXCHANGE RESERVES AT ACCEPTABLE LEVELS. THEY ARE ALSO DEPENDING HEAVILY ON NEGOTIATING CONCESSIONS ON THEIR EXISTING EXTERNAL DEBT AND ON OBTAINING NEW FUNDING FROM FOREIGN SOURCES TO CONSERVE RESERVES, AND MORE IMPORTANTLY, TO HELP GET THE ECONOMY GROWING AGAIN.

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DRAFTED BY J.V.SWEENEY. PILLIOD
ADMIN
END OF MESSAGE

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